

Internal Revenue Service
memorandum

CC:TL
Br3:FJElward

date: JUN 05 1986

to: District Counsel, Phoenix SW:PNX

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]

Your memorandum of March 18, 1986, requested technical advice on a number of issues in the above case.

In the absence of a settlement, it is anticipated that the issues which are the subject of this technical advice will be submitted to the court (Judge Swift) under rule 122.

ISSUES

Does the term "investment expense", as used in Code section 163(d)(3)(C) include a non-business bad debt described on Code section 166(d)?

Even though the bad debt required the payment of interest, if no interest is paid, is such debt "directly connected with the production of investment income"?

Is the non-business bad debt a "deduction under Code section 166" so as to be included in Code section 163(d)(3)(C)?

Whether the non-business bad debt is used in computing net investment income only to the extent of the actual deduction claimed by the taxpayer for the taxable year?

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CONCLUSIONS

Your memorandum sets forth the following proposed positions. You propose to support the determination of the statutory notice of deficiency and argue (1) that the non-business bad debt under section 166(d) is indeed a deduction eligible for inclusion as an investment interest expense under section 163(d); (2) that the \$[REDACTED] purchase note cancelled in [REDACTED] is "directly connected" to investment income as is the cancellation of the remaining balance of the [REDACTED] note because the purchase note in fact generated investment income (interest) and the [REDACTED] note had the potential of doing so; (3) the amount of the non-business bad debt deduction for purposes of the section 163(d) net investment interest calculation is limited to the deduction actually utilized by the taxpayer in the subject year. We concur.

FACTS

The facts, as stated in your March 18, 1986, memorandum, are summarized as follows. [REDACTED] is the chief executive officer of [REDACTED], [REDACTED] American home builder. He has an extensive portfolio of investments, including the stock and notes pertinent to your advice request. The taxpayers describe the operative facts as follows:

Prior to 1975, taxpayer had owned all of the stock of [REDACTED]. Taxpayers had a basis in their stock of \$[REDACTED]. The taxpayers also had made cash advances of \$[REDACTED] to [REDACTED] (the "note"). No interest was ever paid on these advances. No dividends were ever paid on the stock of [REDACTED].

In [REDACTED], taxpayers sold all of the stock of [REDACTED] to [REDACTED] in exchange for a note of \$[REDACTED] (the "purchase note"). Taxpayers did not elect installment treatment on this sale, and recognized \$[REDACTED] of income in [REDACTED]. From [REDACTED] to [REDACTED], [REDACTED] continued to fail to pay interest on the note.

In [REDACTED], [REDACTED], after having paid approximately \$[REDACTED] in principal on the purchase note, threatened to default on it. Rather than foreclose on the purchase note, the taxpayers agreed to a cancellation of \$[REDACTED] of the [REDACTED] note and all of the remaining balance of the purchase note from [REDACTED]. [REDACTED] then paid the rest of its note to the taxpayers by assuming a liability of \$[REDACTED] which the taxpayers owed to a third party.

██████████ is related somehow to ██████████, a
██████████ lender to the taxpayers. The \$██████████ was an
amount owed by the taxpayers to ██████████.

██████████ owned all the stock of ██████████
after the sale in ██████████ and continued to hold the stock
throughout the years at issue. The stock of ██████████
was owned by ██████████ who is unrelated to the ██████████.

The net effect of these peculiar events (according to the
taxpayers) produced a non-business bad debt wholly worthless in
██████████ in the amount of \$██████████. 1/ They deducted that amount
against short-term capital gain (to the extent of \$██████████). 2/
Specifically, the non-business bad debt is the product of:

Taxpayers forgave ██████████ debt	\$██████████
Taxpayers forgave ██████████ purchase note	\$██████████
██████████ assumes taxpayer debt to ██████████	██████████
Net	\$██████████

At the time of the transaction, ██████████ was a
wholly owned subsidiary of ██████████.

1/ In their ██████████ letter petitioners refine the
characterization of what took place to be (1) the cancellation
of the ██████████ purchase note, (2) a cancellation of a part
██████████ of the ██████████ note, and (3) the "payment"
of the balance of the ██████████ note by ██████████'s assumption
of the \$██████████.

2/ There are two other possible characterizations of the ██████████
transactions of course. First, it could be deemed a gift by the
taxpayers to shareholders of ██████████; or, the
entire transaction may be deemed a sale or exchange resulting in
long-term capital loss. See Levy v. Commissioner 131 F2d 544 (2
Cir., 1942); but see also Michell v. Commissioner 187 F2d 706 of
the short term capital loss treatment of a non-business bad debt
but will not have the limitation on net investment income
described in this technical advice request. We believe the
additional requested facts will not change the characterization
of the transaction from that allowed by the examining agent and
the appeals division, namely, a non-business bad debt.

During [REDACTED], \$[REDACTED] of interest was paid by the taxpayers to [REDACTED] on account of [REDACTED]. At the same time, the taxpayers reported [REDACTED] investment income in the amount of \$[REDACTED] consisting primarily of interest income and net-dividend income. Included in the investment income is \$[REDACTED] from [REDACTED], another name for the [REDACTED]. The interest income was earned on the purchase note executed by [REDACTED] to the taxpayers at the time of the purchase of the [REDACTED] stock.

ANALYSIS

Your conclusions are based on the Code and the legislative history. You conclude that losses such as that sustained by the petitioners are deductions directly related to the production of investment interest; therefore, they must be taken into account under Code section 163(d)(3)(C) as investment expenses in calculating "net investment income". We agree.

The taxpayers, on the other hand, urge mainly that a non-business bad debt is not a deduction since the Code requires it to be treated as a short term capital loss. We agree with your analysis in support of the agent's conclusion that although the Code requires non-business bad debts to be treated as losses, they are still considered deductions for purposes of Code section 163(d)(3)(C). We agree with your reading based on the language and purpose of the provision. The taxpayers' position would produce an anomolous result from a strained reading of the Code.

Taxpayers contend, alternatively, that Code section 163(d)(3)(C) must be given a very restrictive reading so that only in a few instances business bad debts would be considered as investment expenses. To state such a proposition is to demonstrate how clearly wrong it is. The investment interest limitation does not apply to business income and expense. Investment income and expense are usually related to the production of long term gains. The purpose of the calculation of net investment income is to permit additional interest deductions to the extent of net investment income because this does not defeat the plain purpose of the investment interest limitation-preventing the mismatching of investment expenses against otherwise currently taxable income. The reading for which taxpayer contends is incompatable with the purpose of the investment interest limitation as is manifest from its language and its legislative history, particularly that cited in your request.

Finally, taxpayer contends that a non-business bad debt is not directly connected with the production of investment income; therefore, it is not to be taken into account in computing net investment income. Taxpayers would read the statute so literally as to produce an absurdity. We agree with your reading for the reasons stated.

ROBERT P. RUWE
Director

By: 

DANIEL J. WILES
Chief, Branch No. 3
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